Global Tax Alert

IRS rules on application of manufacturing exception where sales activities did not include taking of title

Executive summary

In a private letter ruling (PLR 201325005), the Internal Revenue Service (IRS) addressed the application of the manufacturing exception under Treas. Reg. Section 1.954-3(a)(4)(i) with respect to sales commissions derived by a foreign branch (Branch) of a foreign partnership (Foreign Partnership), which was wholly owned by several related controlled foreign corporations (each a CFC). The PLR concluded that the Branch’s commission income was not foreign base company sales income (FBCSI) because the Branch made a substantial contribution to the manufacture of the products sold, within the meaning of Treas. Reg. Section 1.954-3(a)(4)(iv), even though the Branch did not hold or pass legal title to the products sold. The ruling contains a representation of the Taxpayer stating that all of Branch’s income will be considered sales income and, therefore, tested to see if it is FBCSI and will not be treated as services income and, therefore, tested to see if it is foreign base company services income (FBCSvI), under Section 954(e). Despite including this representation, the ruling does not further elaborate on, or discuss, the issue of whether the income might also be treated as services income. Given that the activities of Branch appear to take place outside the country of incorporation of the CFC partners, it appears that if the income were treated as services income it would be classified as FBCSvI. Therefore, the ruling does not provide any further clarity as to whether income that relates to both sales and service type activities should be tested under only one or under both of FBCSI and FBCSvI categories of subpart F, although the implication is certainly that it only needs be tested as sales income.
Detailed discussion

**Facts**
The key relevant facts set forth in the ruling are the following. Taxpayer requesting the ruling was the US parent company (Parent) of a US based multinational group. Parent and a wholly owned domestic subsidiary (Domestic Subsidiary) of Parent, jointly own FSub-1, a Country S corporation. FSub-1 wholly owns FSub-2, a Country T corporation, which in turn wholly owns FSub-3, a Country T corporation as well. FSub-1, FSub-2 and FSub-3 are all treated as corporations for US tax purposes and are treated as controlled foreign corporations (CFC) under Section 957(a).

In addition, Parent directly and indirectly wholly owns several other foreign corporations, all of which are organized in jurisdictions other than Country T and Country U and are regarded as corporations for US tax purposes and are treated as controlled foreign corporations (CFC) under Section 957(a).

Specifically with respect to products sold in Country T, FSub-3, as a cost-plus, limited risk manufacturer, purchases raw materials from both related and unrelated suppliers and performs manufacturing activities to turn the raw materials into finished products. Subsequently, FSub-3 sells the manufactured products to FSub-2, which operates as a Country T-based principal and distributor of the products purchased from FSub-3. FSub-2, in turn, sells the products to unrelated third party dealers in Country T. Branch, operating as a principal and through the activities of its employees located in Country U, provides overall support to the manufacture, marketing and sale of products sold by FSub-2. Branch is compensated by FSub-2 for its role at a percentage of the proceeds from the sale of the products in Country T.

Although Branch is significantly involved in the manufacturing, marketing, and selling activities with respect to products sold in Country T (Products), it never takes legal title to the raw materials, work in process or the finished goods for such products sold.

Taxpayer represented that Branch makes substantial contribution to the manufacture, production, or construction of Products sold in Country T within meaning of Treas. Reg. Section 1.954-3(a)(4)(iv). Taxpayer further represented that regardless of whether the income of its CFCs from the sale of personal property to any person on behalf of a related person, or the purchase of personal property from any person on behalf of a related person could constitute FBCSvI under Section 954(e), Taxpayer will treat such income as FBCSI. (Sorry I messed up the formatting.)

**Law and analysis**
A US Shareholder of a CFC is required to currently include its pro rata share of such CFC’s subpart F income, which includes FBCSI and FBCSvI. Under Section 954(d) FBCSI includes income derived in connection with purchasing or selling personal property from, or to, or on behalf of, related persons if such personal property is manufactured or produced outside the country in which the CFC is organized and sold or purchased for use, consumption, or disposition outside such country. Under Section 954(e) FBCSvI includes income derived in connection with the performance of technical, managerial, engineering, architectural, scientific, skilled, industrial, commercial, or like services which are performed for or on behalf of any related person, and which are performed outside the CFC’s country of organization. Both FBCSI and FBCSvI can include income in the form of commissions, fees or other similar payments.

Treas. Reg. Section 1.952-1(g)(1) provides that partnership income allocated to a CFC which is a partner in such a partnership would be classified as subpart F income, to the extent that the income would have been classified as subpart F income.
if received by the CFC directly. For that purpose, any determination required for the purpose of FBCSI or FBCSvi is to be made directly by reference to the CFC and not by reference to the partnership.

Without any stated analysis, the IRS classified the income earned by Branch (and therefore allocated to the Partners) as sales income that needed to be tested to determine if it was FBCSI. The IRS further concluded that although Branch does not take or pass legal title to Products sold in Country T, the income from the payments received by Branch from the sale of the Products is excluded from FBCSI pursuant to the “manufacturing exception” under Treas. Reg. Section 1.954-3(a)(4)(i). In this regard, most practitioners had assumed that a CFC deriving commission income could qualify as a substantial contributor, and this ruling confirms that conclusion.

The treatment of a type of income can overlap multiple categories of subpart F income. The regulations under Section 954 provide that an item of income is not excluded from one category of subpart F by reason of being included in another category, if the income is excluded from the other category by a specific provision within the statute. The IRS suggested in Revenue Ruling 86-155, 1986-2 C.B. 134, that FBCSvi does not include an item of income that is appropriately classified as sales income. Contract manufacturing activities, for example, can include activities with both a sales and service type nature and therefore blur the line between what type of income is being generated from such activities, sales or services.

Clear guidance does not exist to provide how such activities should be treated for subpart F purposes and whether the income generated from such activities should be tested as both FBCSI and FBCSvi, an issue already recognized by Department of Treasury and the IRS as noted in the preamble to the final contract manufacturing regulations issued in 2011. The ruling here contains a representation of the Taxpayer according to which all of Branch’s income will be considered as FBCSI regardless of whether it could also be classified as FBCSvi - however, this representation seems to be aimed solely at limiting the scope of the relevant discussion, resulting in the ruling not providing further clarity as to whether such activities should be tested under both FBCSI and FBCSvi categories of subpart F or just under one of the categories.

Implications

The ruling provides that if a type of income is considered sales income, then the actual taking of title is not necessary in order for the activities of a CFC or a branch of the CFC to be considered to provide substantial contribution, thereby meeting the requirements of the manufacturing exception under Treas. Reg. Section 1.954-3(a)(4)(i). In this regard, most practitioners had assumed that a CFC deriving commission income could qualify as a substantial contributor, and this ruling confirms that conclusion.
For additional information with respect to this Alert, please contact the following:

**Ernst & Young LLP, International Tax Services, Washington, DC**
- Marjorie Rollinson  +1 202 327 5757  margie.rollinson@ey.com
- Preya Patel  +1 202 327 7476  preya.patel@ey.com

**Ernst & Young LLP, International Tax Services, Chicago**
- Anna Voortman  +1 312 879 3264  anna.voortman@ey.com

**Ernst & Young LLP, International Tax Services, San Francisco**
- Stephen Bates  +1 415 894 8190  stephen.bates@ey.com

**Ernst & Young LLP, International Tax Services, New York**
- Alon Kritzman  +1 212 773 6961  alon.kritzman@ey.com
About EY
EY is a global leader in assurance, tax, transaction and advisory services. The insights and quality services we deliver help build trust and confidence in the capital markets and in economies the world over. We develop outstanding leaders who team to deliver on our promises to all of our stakeholders. In so doing, we play a critical role in building a better working world for our people, for our clients and for our communities.

EY refers to the global organization and/or one or more of the member firms of Ernst & Young Global Limited, each of which is a separate legal entity. Ernst & Young Global Limited, a UK company limited by guarantee, does not provide services to clients. For more information about our organization, please visit ey.com.

© 2013 EYGM Limited.
All Rights Reserved.

SCORE No. CM3615

This material has been prepared for general informational purposes only and is not intended to be relied upon as accounting, tax, or other professional advice. Please refer to your advisors for specific advice.

ey.com